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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/174

10:00 a.m., October 30, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	D. Saha, Temporary
	M. K. Bush
	P. Péterfalvy, Temporary
M. Finaish	
	T. Morita, Temporary
	K.-H. Kleine, Temporary
	Song G., Temporary
	Jaafar A.
	H. A. Arias
	M. Foot
	S. Simonsen, Temporary
	O. S.-M. Bethel, Temporary
	A. Abdallah
	C. A. Salinas, Temporary
	L. P. Ebrill, Temporary
P. Pérez	G. Ortiz
H. Ploix	
	J. de Beaufort Wijnholds
C. R. Rye	A. V. Romuáldez
	O. Kabbaj
	A. Vasudevan, Temporary
	F. Di Mauro, Temporary

A. Wright, Acting Secretary
J. K. Bungay, Assistant

Also Present

IBRD: G. Park, Latin America and the Caribbean Regional Office. Asian Department: D. J. Goldsbrough. Central Banking Department: J. T. J. Baliño, L. E. Molho. Exchange and Trade Relations Department: M. Guitián, K. Flug. Fiscal Affairs Department: L. J. Vasquez-Caro. Legal Department: J. V. Surr. Western Hemisphere Department: S. T. Beza, Associate Director; M. Caiola, L. E. Escobar, J. Ferrán, M. R. Figuerola, I. C. Tandeciarz, S. Umana. Bureau of Statistics: E. Ayales. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, G. Pineau, R. Valladares. Assistants to Executive Directors: J. de la Herrán, G. Ercel, R. Fox, G. K. Hodges, J. M. Jones, M. Lundsager, G. Seyler, D. A. Woodward.

1. MEXICO - REPORT BY DEPUTY MANAGING DIRECTOR

The Deputy Managing Director reported that he had participated in presentations regarding the financing package for Mexico in Toronto, San Francisco, and Tokyo, along with representatives from the World Bank and the Government of Mexico. In addition, a spokesman from the central bank of each country had made a presentation, which the commercial banks had interpreted as a general statement of support for the efforts to arrange the financing package. However, the central bank representatives had made it clear that it was the decision of the commercial banks to participate, and the central banks were neither pressing for--nor providing special concessions to encourage--the banks' participation. The central banks took the position that a financing package to support an economic program to bring about improved economic circumstances and to enhance Mexico's ability to service its debts was in the interest of banks that were lending to the country or held claims there. At the same time, presentations had been made in Europe, in which the Director of the Western Hemisphere Department and the Deputy Director of the Office in Europe had participated. The target date for the financing package remained October 31, 1986. He expected to be in touch with the banks during the course of the next two days concerning the status of the package.

He had been impressed by the amount of preparation that had been made by the banks before each session, despite a very short lead time for those sessions, the Deputy Managing Director added. That advance preparation had been reflected in the quality of the sessions in each city.

2. COSTA RICA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Costa Rica (SM/86/241, 9/15/86). They also had before them a background paper on recent economic developments in Costa Rica (SM/86/250, 10/3/86).

Mr. Pérez made the following statement:

> My authorities would like to express their appreciation to the Fund staff for the constructive discussions held in connection with the 1986 Article IV consultations. They have also given me indications that they are in broad agreement with the staff analysis. Since the Board has had several opportunities to review the economic situation of Costa Rica during the past year, and given the comprehensive nature of the staff reports, I will restrict my remarks to a brief overview of the adjustment process and a review of some recent events and policy issues.

At the end of the 1970s and the beginning of the 1980s, Costa Rica suffered a series of external shocks that led to a severe economic crisis. In addition to the external difficulties that besieged developing countries in general--such as the sharp decline in world economic activity and the rise in real interest rates--the Costa Rican economy was affected by the political problems of the region, reflected in a contraction of the Central American Common Market and a breakdown of the system of regional payments. The deterioration of the economic situation can be illustrated with a few indicators: in 1982, real GDP declined more than 7 percent; consumer prices increased 82 percent; the current account deficit amounted to 9 percent of GDP; the combined public sector deficit reached 15 percent of GDP; gross domestic savings declined to 16 percent of GDP; and the external debt/GDP ratio reached 121 percent.

The adjustment process followed since 1982, which includes two one-year stand-by arrangements with the Fund, has produced the following results: output has increased 11 percent in real terms during the period 1983-85; the rate of inflation--as measured by the rate of growth of the CPI--has declined steadily, reaching 11 percent in 1985; the current account deficit also declined to 4.5 percent; the public sector deficit was cut to less than 8 percent; gross domestic savings rose to 24 percent; and the debt/GDP ratio was reduced by approximately 20 percentage points.

Progress is evident, although the pace has not been even throughout the period. However, given the magnitude of the initial desequilibria, the size of the foreign debt, and the political problems affecting the region, it would be unrealistic to expect an untroubled adjustment process. Nonetheless, the authorities have reiterated their decision to strengthen adjustment policies and to continue with the process of structural change. To this end, apart from reinforcing demand management measures, the authorities intend to utilize the available policy instruments, including structural measures, promote exports and enhance the import capacity of the country as a major priority. My authorities are of the view that the debt burden constitutes a serious obstacle for the effective implementation of structural changes without endangering the political and social stability of the democratic institutions. These changes are of the essence for ensuring a definite improvement of growth perspectives; thus, the authorities are actively negotiating with multilateral organizations, bilateral agencies, and commercial banks in order to obtain the necessary finance that will permit adequate output and export growth.

In relation to the performance under the latest stand-by arrangement, my authorities wish to point out that the delays in disbursing US$40 million from official agencies, and an equal amount corresponding to the second tranche of a Structural

Adjustment Loan (SAL) from the World Bank, contributed to aggravate the accumulation of arrears and the deviations from the targets for the accumulation of international reserves and other performance criteria affected by this problem. In fact, the amount of arrears accumulated in March 1986, US$100 million, corresponds to the above-mentioned amounts plus the Fund purchase that was not effected. Opportunely, the authorities expressed reservations regarding proposed changes of the definitions of international reserves and arrears that were originally agreed upon. In addition, they emphasized that the apparent increase in the operating losses of the Central Bank is wholly explained by a change in the methodology of measurement, so that the figure for 1985 is not comparable to the losses registered for previous years.

The new Administration has already taken a number of steps to reactivate structural policies and to contain government expenditures in view of the widening of the deficit observed during the first half of the year. This is partially explained by the sluggishness of fiscal revenues. On the other hand, the second tranche of the SAL has already been disbursed.

Wage policy has been revised in 1986 so as to ensure compatibility with price and financial stability. Private sector negotiations will be based on the evolution of consumer prices and productivity, rather than exclusively on the behavior of the basic basket. In the public sector, negotiations will henceforth be conducted on the basis of expected rather than past inflation.

The additional income in the external current account derived from higher coffee prices, lower interest rates and petroleum prices envisaged for 1986, will be offset by lower inflows to the capital account. However, the outlook for nontraditional exports continues to be quite favorable; this type of exports has increased 40 percent in 1986, and now constitutes 25 percent of total exports versus 14 percent in 1982. Exchange rate policy will continue to be managed in a flexible manner to induce further export growth compatible with the planned tariff reductions, but care will be exercised at the same time not to fuel inflationary pressures.

As for the medium-term scenario, the authorities wish to reiterate their view that the case of small, highly indebted countries merits special attention. The only permanent solution of Costa Rica's debt problem is the recovery of adequate growth rates, above 4 percent a year. It is then necessary for the internal adjustment and structural change efforts to be strongly supported by the international financial community. The authorities wish to indicate their intention to seek continued close collaboration with the IMF in the design and implementation of a growth-oriented adjustment strategy.

Mr. Arias made the following statement:

The economy of Costa Rica performed well during the first half of 1985, but it appears that the momentum of reorienting the economy toward a better performance has since slackened. There had been deviations in many economic policy areas that consequently hindered the process of restoring internal and external balance. I welcome the authorities' intention to rescue the economy from its current situation by the implementation of some measures conducive to the improvement of the public finances. In this respect, it is encouraging to note the various price and incomes policy measures taken in May 1986. By the same token, it is encouraging to note the emphasis that the authorities are giving to the implementation of structural reforms in the financial, trade, and fiscal areas. The adjustments planned in these areas should result not only in substantial financial strengthening of the public sector, but are also aimed at promoting exports while improving productivity and market competition by reducing effective tariff protection as well as reducing the size of the public sector.

The strict expenditure control measures taken by the Government are noteworthy, specifically the decision to reduce the level of utilization of budgetary authorizations. However, since further measures will be needed for 1987, I would like to know whether there were any discussions on the possibilities of implementing new revenue measures to offset in part the losses of the Central Bank. Emphasis should of course be placed on containing the latter.

In the context of the authorities' effort to embark on an adequate adjustment path, a cautious wage policy will be crucial. I am confident that the authorities will do their best to adopt the necessary measures to regularize the current economic situation. As Mr. Pérez has mentioned--and I agree with him--Costa Rica is suffering from serious debt servicing problems. The authorities' success in implementing adjustment will depend to a large extent on the supportive approach that the international financial community assumes.

Mr. Bethel made the following statement:

The authorities are to be commended for the achievements made in the adjustment process, which has extended over the past four years, encompassing two stand-by arrangements. However, the process has not been sustained continuously. Periods characterized by significant adjustment have alternated with periods in which policies have been relaxed. Despite the many economic gains--lower inflation, improved exchange rate management, and strengthened position of the nonfinancial public sector--Costa Rica continues to to be burdened by a weak external position and by structural rigidities that adversely affect the performance of output and exports.

The authorities' commitment to adjustment--which appears unquestionable, according to Mr. Pérez's statement--must continue. Despite the failure to meet certain performance criteria, and in view of the related slippages in fiscal, monetary, and wage policies, it is advisable to pursue an even more aggressive adjustment program.

Policies more conducive to growth and investment potential are desirable. The authorities must address the problem of an increasing fiscal deficit in the central administration, and take measures to reduce the rising current account deficits and financing gaps in the medium term. The combined fiscal deficit rose by more than 1 percent of GDP instead of the planned decline of 1 percent. Attention must be given to the efficient operation of the public enterprises; and where possible, they should be allowed to become financially self-supporting through appropriate pricing policies. Support in the form of subsidies or transfers is inconsistent with efficiency. The authorities have stated their intention of restraining public sector employment; however, there is concern that any decrease in employment will have little or no effect when considered against the Government's proposed wage negotiation process and indexation. We would urge the authorities to reconsider this process and follow a more cautious wage policy, and we note Mr. Pérez's statement indicating a shift of direction in this area. That policy will ultimately affect both the country's competitiveness and investment-generating capacity.

The continuing indebtedness and large losses of the Central Bank limit the scope of monetary policy and place more of the adjustment burden on fiscal policy. It also decreases confidence in the financial system. Therefore, the authorities are encouraged to continue their efforts, albeit more determinedly, at allocating these losses to the fiscal accounts. Measures taken in this area will also determine the extent of private sector access to credit for investment purposes.

I am encouraged by the authorities' recognition of the necessity to develop an export-led growth strategy and the implementation of structural reforms aimed at reducing the rigidities in the economy. Such measures, when enhanced by adequate incentives and a flexible exchange rate policy, will create a competitive environment for both traditional and nontraditional exports. Further, the potential of the manufacturing sector in assisting export-led growth will be realized only if there is a shift in emphasis from import-substitution production to export-oriented production. The Customs Tariff Reform is a welcome measure to reduce high levels of protection and reinforce the country's competitive position.

The authorities have also proposed to lower tax rates and broaden the income tax base. However, while this is commendable, there is also a need to reinforce the tax collection method, and priority must still be given to expenditure-reduction efforts.

We support the authorities in their adjustment policies, which are basically in line with the objectives of the previous stand-by arrangement. However, we would encourage the authorities to take advantage of the current favorable developments in coffee and petroleum prices to improve the state of their public finances. Costa Rica remains quite vulnerable to external shock, and given its weak external prospects and heavy external obligations, it will have a continous need for substantial debt relief. The continued support of the World Bank is encouraging, and we would like to believe that there is still scope for assistance from the Fund.

Mr. Foot noted that Costa Rica's external arrears had risen from about $33 million at end-1985 to $95 million at end-July 1986. Since then, according to the press, Costa Rica had made few if any payments of interest on its external debt, and had made little progress in rescheduling its bank debt. Costa Rica had made suggestions on the terms of the rescheduling, which was unlikely to advance the negotiations rapidly. Therefore, he urged the authorities to take due account of the fact that anything that appeared to be unilateral suspension of debt payments was a serious act that could only damage the borrower's name in the financial community. Costa Rica's need for rescheduling its debt by negotiations would not be fulfilled by unilateral action.

Ms. Bush made the following statement:

In the period since the 1985 Article IV consultation discussion (EBM/85/136, 9/10/85), the Costa Rican authorities unfortunately have not succeeded in restoring the momentum of adjustment that had been initiated under the 1985 stand-by arrangement. This is disappointing in the light of the convergence of several favorable exogenous developments, including the drop in interest rates and petroleum prices and the rise in coffee prices. In fact, the policy slippages that have occurred give rise to a number of concerns related in particular to the large size of the consolidated fiscal deficit, including the losses of the Central Bank, and the possible erosion of competitiveness that may be resulting from the substantial increases in real wages over the past few years.

As Mr. Pérez has pointed out, the authorities--who have been in office just a few months--are now indicating that they are considering appropriate actions to stem the deterioration in the fiscal and trade positions. We welcome their commitment to implement the requisite policy adjustments, and we urge them to move promptly in a number of areas to contain this year's fiscal deficit and to lay the groundwork for a much improved outcome in 1987.

The authorities appear to hold the view that in the medium term, growth and payments viability can be attained best by export growth. The recent high increases in real wages thus give rise to some concerns that competitiveness will be difficult to sustain. In that regard, I wonder whether staff could assess the continued real effective depreciation of the colon with reference to developments in real wages, since the charts on page 6a of the staff report appear to indicate that competitiveness is being maintained. We welcome the authorities' continued commitment to exchange rate flexibility, but we would view as equally important a commitment to contain domestic cost and price pressures, in order to avoid a cycle of inflation and depreciation. We place particular emphasis on the containment of wages, and urge the authorities to keep in mind the need for competitiveness as they plan the frequency and magnitude of wage adjustments. Other areas important to the development of the growth and export potential of the economy relate to the strengthening of the role of market forces in the economy. Additional steps toward price control have been taken, and efforts are continuing to divest public entities. I wonder whether the staff sees such progress as sufficient, or whether there are additional areas in which producer incentives could be strengthened.

The authorities continue, commendably, to take the lead in regional tariff reform, and are also planning measures to promote exports. However, the staff report does not indicate in what fashion exports would be promoted, and we would welcome any further details.

We found it particularly discouraging that the overall fiscal deficit approached 8 percent of GDP in 1985 when it had been programmed to be under 6 percent. The deficit for 1986 is now projected to remain at about 7.5 percent of GDP, with Central Bank losses exceeding 5 percent of GDP. The authorities are considering providing fiscal resources to cover in part the Central Bank losses arising from public external debt service. We strongly urge them to carry through on this possibility in an effort to make more explicit the domestic costs of external debt service, which could also help focus attention on the aggregate fiscal problem. Other difficulties remain, however, including those arising from the practices of earmarking revenues and maintaining areas of compulsory spending, which greatly limit the ability of the Government to contain fiscal spending. Furthermore, other expansions in Government activity are occurring, despite the limited resources available. In particular, we are concerned that the rather open-ended commitment to expansion of the retirement program could be quite costly. In addition, the authorities are planning to reduce the size of the public sector, and we wonder whether any concrete steps have been taken yet. Finally, we would be interested in staff views on the appropriateness of tax reform aimed at strengthening producer incentives.

As for monetary policy, we have in the past commented extensively on the losses of the Central Bank, and we appreciate the details provided in SM/86/250 (10/3/86). It appears that such losses will continue, thereby necessitating support from the Government, and we would welcome an expanded issuance of treasury bills to permit the retirement of central bank stabilization bonds, thereby increasing the transparency of the fiscal situation. Interest rates on deposits continue to be remunerative, although it would be useful to effect administrative and financial reforms in the banking sector in order to lower lending rates with a view to promoting investment. Action to contain cost-push inflation related to wage increases could also facilitate reductions in interest rates. Finally, we welcome the efforts to increase reliance on open market operations to improve control of banking sector liquidity.

The medium-term outlook makes it clear that Costa Rica will need the continuing support of its external creditors, both commercial and official. The resumption of a comprehensive adjustment program that addresses the fundamental problems that I have mentioned could provide a firm foundation for normalized relations with creditors. In that regard, we hope that the authorities will approach external creditors in a constructive manner, and we hope likewise that the creditors will be prepared to support Costa Rica's adjustment effort. However, this can be expected only if Costa Rica takes positive steps toward regularizing its relations with commercial banks, which implies working with the banks in a cooperative manner to come to agreements on rescheduling, if that is necessary.

Mr. Salinas made the following statement:

During the past several years, economic developments in Costa Rica have been mixed, with periods characterized by significant adjustment and periods in which policies have been relaxed. The 1985-86 Economic Program, supported by the Fund, did not change this particular pattern of economic developments. Some progress was achieved in terms of slowing down the rate of inflation, increasing output, and improving exchange rate management. However, slippages in policy implementation in other areas, together with unexpected delays in the disbursement of external financial resources--from official agencies and from the World Bank--led to a larger than expected public sector deficit, a widening of the current account deficit, and a further accumulation of external arrears. Like previous speakers, we believe that this situation needs to be redressed promptly, in particular to take advantage of the relief provided by favorable external developments associated with coffee and oil prices as well as with the movements in interest rates. Thus we are pleased to note that the Administration that took office in May 1986 is committed to pursue the same macroeconomic objectives and policy approaches that had been supported by the previous stand-by arrangement.

We also welcome the importance that the authorities attach to the implementation of their program of structural adjustment in order to foster economic growth. Structural rigidities in the economy have undoubtedly remained a key factor adversely affecting output and export performances, and they should certainly be removed if the benefits of a stabilization program are to be fully realized. It is our view that the major emphasis should now be placed both on improvement in public sector management, including a reduction in the size of the public sector, and on improved efficiency of the financial system. A combined effort of structural adjustment, in areas in which rigidities play a major role, together with the full implementation of the policies already devised for the fiscal and external areas, should contribute to redressing the current outcomes observed in both fields, mainly in the context of a more favorable external environment.

We agree with the staff that the most worrisome aspect of fiscal policy remains that of the Central Bank operational losses, and that given the limited scope for reducing them, the bulk of the domestic financial adjustment will have to come from a significant improvement in the operations of the nonfinancial public sector. However, we would like to have more detailed information from the staff regarding the extent to which the increase in such losses can be explained by changes in the calculation methods, as Mr. Pérez has stated. Nevertheless, and beyond the reasons explaining the Central Bank's operating losses, it is clear that the authorities must take more decisive action in implementing appropriate measures to strengthen public finances, both in the remainder of 1986 as well as early in 1987. Such measures would have to include not only direct action on revenues and expenditures, but also major reforms in the operations of the entire sector.

In the external area, export growth and efficient import substitution are still required, and should continue to be encouraged by means of a flexible exchange rate policy as well as by further reduction of the existing structural rigidities. In addition, and given the weak external prospects of the economy over the medium term, the authorities will need to strengthen the country's competitiveness not only through flexible exchange rate management, but also by changing the patterns of aggregate demand and by implementing a more cautious wage policy.

On monetary policy, we welcome the intention of the authorities to pursue a flexible and more liberal interest rate policy and to use open market operations to restrain the expansion of bank credit to the private sector, sterilizing part of the liquidity generated by increased coffee export receipts. We also support the authorities' intention to regularize the situation of the Central Bank, possibly by allocating resources from the nonfinancial public sector to cover at least part of the Central Bank's external debt service. We would appreciate an update from the staff or Mr. Pérez on the current status of this possibility.

To conclude, this chair welcomes the steps that the Costa Rican authorities are adopting in order to redress their various domestic and external imbalances, while noting that current external circumstances provide an excellent opportunity for the authorities to reinforce their adjustment efforts, particularly in the fiscal and external areas.

The staff representative from the Western Hemisphere Department said that some of the fiscal measures that were being considered by the authorities to narrow the combined public sector deficit had been included in the 1987 budget presented to the Legislative Assembly on September 30, 1986. Although some of those measures might not provide additional resources in the short term, they could be important sources of revenue in the future. One example was the proposed 12 percent tax on sales of petroleum derivatives by the state refinery. Although at present that measure would only capture part of the refinery's windfall profits, it was expected to be an important source of revenue in the future. The proposed budget also included a further extension of the Emergency Law approved in 1984, by which part of the earmarked revenues would accrue to the Treasury instead of being transferred to the rest of the public sector. In addition, the increase of budgetary appropriations to decentralized agencies would be limited to 8 percent, and there was also a proposal to revoke a law that had been approved in December 1985 allowing all public sector employees to participate in a privileged retirement system that was basically contribution free. Moreover, the authorities were considering the inclusion, in the extraordinary budget to be presented to the Legislative Assembly in January 1987, of an additional package of measures to reduce the combined deficit of the public sector and the losses of the Central Bank by about 2 percent of GDP. The package, although not yet clearly defined, included an increase in the rate and a widening of the base of the sales tax, an increase in property and specific consumption taxes, and some cutbacks in certain low priority programs.

The question of the impact of wage policy on the effective exchange rate had been discussed extensively with the authorities, the staff representative continued. In any case, wage increases were reflected in domestic prices and therefore their effect was included in the calculation of the real effective exchange rate. It was noteworthy that the largest part of the improvement in Costa Rica's real effective exchange rate since mid-1985 had resulted from the depreciation of the U.S. dollar vis-à-vis other currencies. During the first nine months of 1986, a further depreciation of about 3 1/2 percent in real effective terms--in relation to the basket being used for that purpose--had taken place.

The authorities had initiated export promotion efforts some time previously and had intensified those efforts under a World Bank structural adjustment loan, the staff representative noted. One of the main elements of that loan was a reduction in tariff protection and some reductions in tariffs and surcharges had occurred during the first half of 1986. The authorities were also reviewing customs procedures. Up to the present time, anyone who wished to export items was required to go through 13 different stages with multiple agencies. It was expected that simplified procedures would be in place before the end of 1986. The authorities were also planning to modernize the port facility in order to lower handling costs.

In recent months, other tax measures had been introduced to promote exports, the staff representative went on. In October 1985, large exemptions had been granted to the tourism sector. It was also noteworthy that exporters did not generally pay duties on imported inputs or capital goods imports, and they were exempted from income tax for periods of 10 to 15 years, so that from a general viewpoint, it could be said that the tax incentives existed. In addition, during the first half of 1986, the authorities had started issuing tax credit certificates for exports of beef but they had had to reverse that measure because of a possibility that countervailing duties would be applied on those exports.

The authorities were moving toward a more liberalized system of controlled prices, particularly in the case of basic grains, the staff representative indicated. Producer as well as consumer prices of basic grains had been controlled to date by the Government, and in some situations, producer prices had been higher than consumer prices. However, most of those distortions had been eliminated.

The staff had made adjustments to the net international reserves of the Central Bank at end-1985 to take account of a float in the payment of import arrears and to account for certain short-term foreign loans classified as medium-term liabilities by the Central Bank, the staff representative explained. The adjustment with respect to import arrears was similar to one that had been made earlier in tests of compliance with performance criteria applicable to March 1985. The authorities had raised a question on the second kind of adjustment on the grounds that it was not clear in the Technical Memorandum of Understanding how those transactions would be treated in monitoring compliance with performance criteria. The staff had explained that it was not possible to anticipate all the contingencies when guidelines were developed for the calculation of performance criteria. Furthermore, when unforeseen developments occurred, consultation was warranted with a view to preserving the spirit and intent of the program. In the situation involving Costa Rica, consultation would have been appropriate, because the size of the adjustment was equivalent to about 3/4 of 1 percent of GDP.

From an economic point of view, it was of interest to note that if the unplanned conversion were counted as an improvement in the net international reserves of the Central Bank to measure the balance of payments test, it would have involved permitting a higher expenditure path and external current deficit than planned in the program, as well as a higher level of external indebtedness, the staff representative added. Rather than to allow a higher spending path, the staff held the view that the unanticipated rescheduling should have been directed to strengthening the net foreign reserve position above the minimum that had been envisaged under the program.

A meeting between the Costa Rican representatives and commercial bank creditors had been held in New York the previous week, the staff representative recalled. The main issues discussed had been the settlement of outstanding arrears on interest due since July 1, 1986--which at end-September amounted to about $33 million--and a rescheduling proposal that had been made by the Costa Rican Government. The staff understood that the Costa Rican representative had explained to the banks that, given the cash flow of Costa Rica, the authorities were unable to be current with interest payments in 1986. However, they had offered to make partial monthly payments of about $5 million, which would be approximately half the amount falling due each month. As a goodwill gesture, the authorities had made the first of such payments during the week of the meeting with the commercial banks. The Costa Rican authorities had also proposed a 25-year rescheduling of the country's debt, with 7 years of grace. The proposal included a limit in total debt service payments to banks of no more than 1 1/2 percent of GDP, with interest rates fixed at 4 percent until 1988, followed by a gradual rise to 6 percent in 1993. That proposal had not been accepted by the banks, but it was agreed that informal contacts would continue with the aim of developing terms that would be satisfactory to both parties. It had also been agreed that formal discussions would be resumed only when understandings, in the form of a letter of intent, had been reached on a Fund-supported program.

Mr. Pérez pointed out that Costa Rica had conducted an impressive adjustment effort to date. His opening remarks illustrated the magnitude of the corrections that the authorities had made during the past three years, and it was in that perspective that Executive Directors should assess the country's economic performance, rather than focusing on quite specific short-term developments.

His authorities recognized that some slippages had occurred, primarily in fiscal performance, Mr. Pérez emphasized. However, with regard to performance in other fields--such as the losses of the Central Bank and missed targets for international reserves--the changes in accounting procedures and methodology had made it impossible to compare the figures presented in the staff report with those of previous years. The changes in methodology also precluded comparisons between the figures on the overall fiscal deficit with those in the program.

As for the arrears of Costa Rica, the new Government that had taken office on May 1, 1986 had informed the commercial banks about its strong intention to maintain the pace of the adjustment, and to respect financial agreements already in force, Mr. Pérez stated. At the same time, the authorities had announced their interest in starting negotiations leading to a new arrangement for the refinancing of all external debt owed to commercial banks as of June 30, 1986 and interest payable on debts to commercial banks since June 30, 1986. In that connection, the new Government had made a payment covering all interest accrued as of end-June 1986. As the staff had indicated, the authorities had presented a proposal during the previous week to commercial banks, with the intention of negotiating a refinancing of all the external debt of Costa Rica. At the same time, the authorities were trying to finalize negotiations with the Fund with respect to a new stand-by arrangement. The banks' coordinating committee held the view that those negotiations should not start before a letter of intent was agreed with the Fund. Despite the interest of his authorities in initiating negotiations as soon as possible, they had accepted that postponement in order to maintain the best relations with the banks. In that context, the authorities expected to reach understandings in the form of a letter of intent during the visit in November 1986 of the Fund mission. In the meantime, Costa Rica had made partial payments on interest accrued since June 30, 1986, and the authorities had every intention of maintaining such payments in the future, subject to the availability of foreign currency.

The Chairman made the following summing up:

Executive Directors were in general agreement with the thrust of the appraisal in the staff report for the 1986 Article IV consultation with Costa Rica. Directors welcomed the measures adopted by the new Administration to reduce the level of effective protection and to adjust consumer and producer prices of essential commodities, as well as the authorities' intention to implement a program of structural reforms in order to help foster the attainment of a sustainable external position and a resumption of sound economic growth.

Directors expressed concern, however, about the relaxation in financial policies that had occurred during the latter part of 1985 and early 1986, which had prevented Costa Rica from achieving some of the objectives of the last stand-by arrangement. That relaxation in policies, together with the subsequent lack of enough corrective measures, meant that most of the benefits arising from higher coffee prices, lower petroleum prices, and falling interest rates that had taken place in 1986 would not be translated into improvements in the fiscal position and economic performance more generally. Directors stressed the importance of persevering with the needed adjustment path and urged the authorities to define and implement an economic and financial program to correct existing imbalances as soon as possible.

Directors welcomed the authorities' intention to allocate resources from the nonfinancial public sector to cover part of the Central Bank's losses so as to make more transparent the extent of the fiscal imbalance. That action would need to be followed by prompt and decisive steps to deal with the fiscal problem. In that connection, Directors emphasized the need for expenditure restraint and the adoption of measures to reduce the size of the public sector, but they also indicated that action to improve revenue performance and tax collection would be required. Directors emphasized the need to intensify the process of divestiture of state enterprises and fiscal reform with respect to revenue earmarking; they noted that the progress made to date in those areas had been limited.

A number of Directors considered that the authorities' efforts in the fiscal area would have to be supported by a tightening in the stance of wage policy. They observed that recent wage rises had exceeded the increases in the consumer price index by a significant margin, and cautioned the authorities about the negative effects that real wage increases not backed by productivity gains would have on domestic prices and on the competitiveness of Costa Rican exports.

The authorities' intention to follow a prudent credit policy was considered advisable, particularly in view of the expected increase in liquidity arising from higher coffee export receipts. The importance of continuing with a flexible interest rate policy aimed at promoting savings in domestic currency was highlighted by several Directors. While welcoming the authorities' adoption of measures aimed at liberalizing interest rates, Directors also recommended speedy action to improve the operational efficiency of banks, with a view to reducing the existing large spread between deposit and lending interest rates.

Directors drew attention to the challenges posed to economic policies in the period ahead by the magnitude of Costa Rica's debt problem and its large external imbalances. In that connection, Directors highlighted the importance of fostering export growth. Toward that end, some Directors considered that the continuation of a flexible exchange rate policy, concurrent with an intensification of external trade reform, would be required to induce changes in the pattern of expenditure and production.

The implementation of an export-oriented growth strategy within the framework of an adequate adjustment program would require, in the Directors' view, the availability of exceptional financing over the medium term. Directors stressed that, in order to obtain the required debt relief and to ensure the continuation of aid inflows, Costa Rica needed to reach cooperative understandings with its foreign creditors on the management of the external debt, including the orderly settlement of arrears. Directors who spoke on that subject regarded further action as a matter of urgency.

It is expected that the next Article IV consultation with Costa Rica will be held on the standard 12-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/173 (10/24/86) and EBM/86/174 (10/30/86).

3. COSTA RICA - TECHNICAL ASSISTANCE

In response to a request from the Costa Rican authorities for technical assistance in the field of monetary policy, the Executive Board approves the proposal set forth in EBD/86/283 (10/22/86).

Adopted October 28, 1986

4. MAURITANIA - TECHNICAL ASSISTANCE

In response to a request from the Mauritanian authorities for technical assistance in the area of taxation, the Executive Board approves the proposal set forth in EBD/86/285 (10/23/86).

Adopted October 29, 1986

5. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/86/254 (10/24/86).

Adopted October 28, 1986

6. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 86/34 through 86/38 are approved. (EBD/86/277, 10/20/86)

Adopted October 24, 1986

b. The minutes of Executive Board Meetings 86/39 through 86/41 are approved. (EBD/86/284, 10/23/86).

Adopted October 29, 1986

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/235, Supplement 1 (10/24/86), EBAP/86/253 (10/24/86), and EBAP/86/257 (10/28/86), by an Advisor to Executive Director as set forth in EBAP/86/253 (10/24/86), and by an Assistant to Executive Director as set forth in EBAP/86/258 (10/28/86) is approved.

8. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/86/256 (10/27/86) is approved.

APPROVED: June 22, 1987

JOSEPH W. LANG, JR.
Acting Secretary